Internal Revenue Service

memorandum

CC:TL-N-473-91
Br2:LSMannix

date: JAN 10 1991

to: District Counsel, Dallas SW:DAL
Attn: Henry C. Griego

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]
Request for Technical Advice

This confirms our oral response to your request for Tax Litigation advice, dated October 12, 1990.

ISSUE

Whether the petitioners realized discharge of indebtedness income upon the transfer of property in full satisfaction of a nonrecourse indebtedness.

RECOMMENDATION

For the reasons stated below, the position that the petitioners' realized discharge of indebtedness income in [redacted] faces severe litigating hazards. Therefore, we recommend not pursuing this argument. This confirms our previous oral advice to you.

FACTS

[redacted] According to your request, the facts are as follows. In [redacted], the petitioners began borrowing money from [redacted] corporation, [redacted] (hereinafter referred to as "[redacted]"). The terms of the loans were contained in promissory notes which were from time to time renewed and consolidated. In [redacted], the petitioners and [redacted] entered into an agreement to convert the recourse notes into a nonrecourse note secured by the petitioners' interest in certain property commonly referred to as the "[redacted]." The [redacted] agreement was finally evidenced by a "[redacted]" dated [redacted], executed by the petitioners in favor of [redacted] in the amount of $[redacted] (hereinafter referred to as the "Note"). The Note states: "[redacted]

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[redacted]."

After a series of transfers in early [redacted], the petitioners' interest in the [redacted] was evidenced by a [redacted]% equity interest in [redacted]. On [redacted], the petitioners transferred $[redacted] cash to [redacted] in partial satisfaction of the Note. On [redacted], the petitioners transferred their [redacted]% interest in [redacted] to [redacted] in full satisfaction of the Note.

The petitioners claim that their [redacted] stock had a value of $[redacted] at the time of the transfer of the stock to [redacted]. They claim that the value of the stock plus the $[redacted] cash transferred to [redacted] exactly equalled the amount of their outstanding debt under the Note ($[redacted] and, thus, the Note was satisfied in full and they did not realize any discharge of indebtedness income.

The petitioners reported $[redacted] in long term capital gain on their [redacted] tax return measured as the difference between the value of the stock transferred ($[redacted]) less their basis in the stock ($[redacted]).

The notice of deficiency asserts that the petitioners realized discharge of indebtedness income in [redacted] measured as the difference between the outstanding indebtedness of $[redacted] less the cash transferred by the petitioners to [redacted]. The notice of deficiency puts a [redacted] value on the [redacted] and, thus, a [redacted] value on the [redacted] stock. Thus, the notice of deficiency asserted that the petitioners had ordinary income in the amount of $[redacted] and a long-term capital loss of $[redacted] (the basis of the stock less the amount realized on its transfer).

DISCUSSION

Your request correctly points out that the transfer of property in satisfaction of a nonrecourse liability cannot result in discharge of indebtedness income even if the fair market value of the property is less than the amount of the outstanding indebtedness. Treas. Reg. § 1.1001-2; Commissioner v. Tufts, 461 U.S. 300 (1982); Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978). Rather, the transfer of the property is treated as a sale or exchange for an amount not less than the outstanding indebtedness. Id. Thus, as long as the indebtedness at issue is treated as nonrecourse debt, the petitioners could not have realized discharge of indebtedness income in [redacted] even if the [redacted] stock had no value.

The only possible argument the Commissioner could make, therefore, is to assert that the indebtedness at issue was, in substance, a recourse liability in [redacted] despite the formal indicia of a nonrecourse debt and the actions of the parties. Under such a theory, the Commissioner would also have to prove that the petitioners valuation of the [redacted] was in error because the amount of discharge of indebtedness income would be the difference between the outstanding indebtedness less the total of the cash plus the value of the [redacted] stock transferred by the petitioners to [redacted]. Your request states that valuing the [redacted] would be extremely difficult because the property is in [redacted] and would involve the valuation of [redacted] and [redacted] leases.

We think that the litigations hazards with respect to such an argument are so great that the argument is not worth pursuing. First, the form of the Note and other documents surrounding the [redacted] and [redacted] transactions evidence a nonrecourse obligation. Second, the actions of the parties in [redacted] is evidence for a nonrecourse liability: specifically, the petitioners transferred the [redacted] property to [redacted] in satisfaction of the indebtedness and [redacted] accepted the property as payment. Third, there is apparently no evidence to indicate that any of the parties considered the Note to be a recourse liability or that the Note was, in fact, a recourse obligation. [1]

An argument could be made that the petitioners would not have transferred the cash to [redacted] in partial satisfaction of the Note if they considered the indebtedness nonrecourse because there is no obligation to satisfy a nonrecourse indebtedness beyond transferring the security. However, the petitioners could argue that they felt morally obligated to satisfy the face amount of the Note. Furthermore, this argument tends to "eat itself" because if the indebtedness was really recourse and the value of the [redacted] was minimal, then the payment of the cash becomes a meaningless gesture: the $[redacted] cash being less than [redacted]% of the $[redacted] indebtedness. In effect, the argument that the indebtedness was really recourse as evidenced by the cash payment conflicts with the argument that the [redacted] had minimal value because the cash payment is significant only because it, along with the property, served to satisfy the full amount of the Note--but it only does so if the [redacted] actually has the value claimed by the petitioners.

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[1] The duty of consistency would not apply here because the petitioners are not taking inconsistent positions with respect to their treatment of the notes or the value of the property. See Beltzer v. United States, 495 F.2d 211 (8th Cir. 1974).

An alternative argument could be made that if the Note was, in substance, nonrecourse, the cash payment could not have been in partial satisfaction of the indebtedness but, instead, must have been a capital contribution to [redacted]. Under such a theory, the petitioners' long-term capital gain would be increased by the amount of the cash payment because it would now be disregarded for the purposes of determining the amount realized upon the transfer of the [redacted] stock. As a capital contribution, the payment would not reduce the amount of the outstanding indebtedness under the Note. The counter argument to this is that the petitioners may have thought they were morally obligated to satisfy the debt in full or that at the time they made the payment--which was approximately a month before they transferred the [redacted] to [redacted]--they intended to pay off the indebtedness in full and only thereafter did they consider transferring the property in satisfaction.

Finally, the petitioners could raise as a defense that if any discharge of indebtedness occurred in any of the transactions at issue, it would have occurred in [redacted] when [redacted] accepted a nonrecourse note in substitution for a recourse note. A finding that a discharge occurred in [redacted] would undercut the Commissioner's assertion that a discharge occurred in [redacted] because the same discharge of indebtedness income would not be recognized twice. [2]

However, even the argument that any discharge would have occurred in [redacted] is problematic because the face values of the exchanged notes were the same: such factor may preclude the realization of discharge of indebtedness income. See Treas. Reg. § 1.61-12(c)(3); Rev. Rul. 77-437, 1977-2 C.B. 28; Rev. Rul. 58-546, 1958-2 C.B. 143; Zappo v. Commissioner, 81 T.C. 77, 86-88 (1983). Thus, this argument would have to include an assertion that the notes were sufficiently different so that the "substitution-of-indebtedness" theory would not apply. See Zappo, supra; Carolina, Clinchfield & Ohio Railway Company v. Commissioner, 82 T.C. 888, 895-898 (1984); Rev. Rul. 89-122, 1989-2 C.B. 200.

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[2] The Commissioner attempted to assert that the petitioners realized discharge of indebtedness income in [redacted] upon the exchange of the notes at issue in [redacted]. However, the Tax Court in that case ruled that the issue was raised too late--the issue was not raised in the notice of deficiency but, rather, the Commissioner attempted to raise the issue by amending his answer--and, therefore, that the Commissioner was barred from asserting it. See [redacted]. Obviously, the Commissioner is now barred from reopening the petitioners' [redacted] taxable year.

The argument that any discharge would have occurred in [redacted] is strengthened by the fact that under no circumstances would a reasonably prudent payee of a note exchange a recourse note for a nonrecourse note without some consideration. Otherwise, the payee of the recourse note would be giving up his right to hold the maker of the note personally liable for its satisfaction. This factor combined with the fact that [redacted] was controlled by the petitioners and their siblings is evidence that [redacted] intended to, and in fact did, partially discharge the petitioners of their liability under the recourse note upon its exchange with the nonrecourse Note.

If the petitioner convinced the court that a discharge could have occurred in [redacted] upon the exchange of the notes, the value of the [redacted] as of the date of the exchange would have to be determined because the income from the discharge would be measured as the difference between the amount of the outstanding indebtedness less the value of the property exchanged: the exchanged property being the Note which would have essentially the same fair market value as the [redacted] which secured the Note. The Commissioner would then be faced with arguing that the value of the [redacted] in [redacted] was equal to the issue price of the recourse note so that no discharge occurred in [redacted]. Such an assertion, however, would tend to undercut the Commissioner's assertion that the property had minimal value in [redacted] under his theory that a discharge of indebtedness occurred in the latter year.

In conclusion, the position that the petitioners' realized discharge of indebtedness income in [redacted] faces severe litigating hazards. Therefore, we recommend not pursuing this argument. This confirms our previous oral advice to you.

If you have any questions, please contact Larry Mannix at FTS 566-3470.

MARLENE GROSS

By: Steven J. Hankin

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Attachments
Background file sent with request